

PART 2

FINANCIAL RESULTS OF THE FIVE BANKING GROUPS

1. PROFIT AND PROFITABILITY OF THE BANKING GROUPS

The improvement in the financial results of the largest five banking groups¹ that started in 2003 persisted in 2005, although the increase was slower than in 2004. Total profit² of the largest five banking groups rose by 25 percent to NIS 6,642 million, compared to a rise of 62 percent in 2004 (Table 1.10). The rise in 2005 did not encompass all the groups, and was not uniform. In the Discount group profit dropped by 12.4 percent due to the early retirement of senior staff and a provision made by Israel Discount Bank of New York³ following an arrangement with the US supervisory authorities.⁴ In the Leumi group profit rose by 12.2 percent, in Hapoalim by 38.6 percent, in Mizrahi-Tefahot by 25 percent, and in the First International by 87.3 percent (Table 1.10).

The rise in net profit increased the equity capital of the five banking groups (equity including minority interests) to NIS 49.2 billion at the end of 2005, from NIS 46.4 billion at the end of 2004.⁵ The rise was partly offset by the distribution of dividends totaling NIS 2.65 billion.⁶ The return on equity (ROE) rose to an all-time high of 15.5 percent, following three consecutive years of increases that derived from the economic recovery among other things, and came after two years of recession (Figure 1.18).

The rise in ROE also varied from one banking group to another: Hapoalim and First International showed marked improvements, Mizrahi-Tefahot and Leumi rose more moderately, and in Discount it actually declined.⁷ With regard to the effect on banks'

¹ Hapoalim, Leumi, Discount, Mizrahi and First International (Beinleumi).

² Defined as net income plus minority interests and translation adjustments accrued to capital.

³ An investigation by the New York District Attorney's Office related to money laundering revealed many shortcomings in Israel Discount Bank of New York in the effectiveness of its controls and in its reporting related to money laundering and the prevention of terrorism. As a result of the findings, the bank was asked, and agreed, to stop acting according to the defective practices, to amend the rules, intensify the control and supervisory procedures in line with those set by the authorities in New York. Israel Discount Bank, the parent company of the New York bank, undertook to make every effort to meet those commitments. The financial statements to December 31, 2005 include a provision of NIS 120 million for fines and consultancy fees related to the above.

⁴ The group's net profit excluding the early retirement provision and the provision for the above agreement between Israel Discount Bank of New York and the US supervisory authorities amounted to NIS 693 million in 2005, up from NIS 659 million in 2004, an increase of 5.2 percent.

⁵ Equity capital includes inter alia other funds and surpluses, i.e., accumulated undistributed past profits.

⁶ In 2005 the Hapoalim group paid dividends totaling NIS 1.65 billion, and Leumi paid NIS 1 billion.

⁷ Even excluding the effect of the provision for early retirement and the special provision for the above agreement relating to Israel Discount Bank of New York, the group's ROE declined to 10.9 percent (compared to an ROE of 11.1 percent in 2004 after excluding the provision for early retirement).

Table 1.10

Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2003–05

	(NIS million, December 2005 prices)																	
	Leumi			Hapoalim			Discount			Mizrahi-Tefahot			First International			Total		
	2003	2004	2005	2003	2004	2005	2003	2004	2005	2003	2004	2005	2003	2004	2005	2003	2004	2005
Net interest income before loan-loss provision	5,975	6,359	6,628	6,715	7,071	7,609	2,983	3,473	3,697	1,439	1,652	1,904	1,349	1,432	1,673	18,461	19,987	21,511
Loan-loss provision	1,883	1,514	1,426	2,359	1,768	1,268	845	880	691	300	359	292	612	437	276	5,999	4,958	3,953
Net interest income after loan-loss provision	4,092	4,845	5,202	4,356	5,303	6,341	2,138	2,593	3,006	1,139	1,293	1,612	737	995	1,397	12,462	15,029	17,558
Total operating and other income of which Fee income	3,216	3,403	3,718	3,665	4,215	4,591	2,091	2,226	2,401	955	1,036	1,114	812	832	1,018	10,739	11,712	12,842
Total operating and other expenses of which Salaries and related expenses	2,507	2,718	2,810	2,929	3,199	3,539	1,648	1,771	1,858	852	874	924	672	718	862	8,608	9,280	9,993
	5,603	5,488	6,070	5,959	6,378	6,991	3,605	4,013	4,724	1,417	1,679	1,839	1,280	1,362	1,575	17,864	18,920	21,199
Ordinary before-tax income ^a	3,370	3,248	3,627	3,526	3,742	4,068	2,264	2,511	2,891	882	1,089	1,154	785	820	906	10,827	11,410	12,646
Tax provision	824	1,244	1,193	861	1,361	1,650	371	342	324	342	255	371	131	211	374	2,529	3,413	3,912
Ordinary after-tax income	1,016	1,516	1,657	1,329	1,779	2,291	283	454	359	372	395	516	178	254	466	3,178	4,398	5,289
Other income ^b	121	388	480	76	379	699	-70	158	177	-10	10	-9	-2	-2	6	115	933	1,353
Shareholders' net income	1,145	1,864	2,136	1,357	2,107	2,908	154	556	458	335	386	507	156	242	453	3,147	5,155	6,462
Total income for calculation of return on equity ^c	1,137	1,904	2,137	1,405	2,158	2,990	213	612	536	362	405	507	176	252	472	3,293	5,331	6,642
Capital for the calculation of ROE^d	13,295	13,293	14,149	13,527	13,892	14,510	5513	5,955	6,386	3718	3,778	4,133	3255	3,497	3,714	39,308	40,414	42,892
Ordinary ROE, net (%)	7.6	11.4	11.7	9.8	12.8	15.8	5.4	7.6	5.6	10.0	10.5	12.5	5.5	7.3	12.5	8.1	10.9	12.3
Total ROE (%)^e	8.6	14.3	15.1	10.4	15.5	20.6	3.9	10.3	8.4	9.7	10.7	12.3	5.4	7.2	12.7	8.4	13.2	15.5
Total return on assets (ROA)(%)	0.50	0.72	0.78	0.60	0.81	1.09	0.20	0.40	0.37	0.50	0.48	0.59	0.30	0.36	0.66	0.40	0.64	0.77

a In 2003 includes erosion and adjustments of income and expenses that were included in before-tax income as reported in statements adjusted for inflation according to the December 2003 CPI (NIS 370 million).

b Includes the group's share in the profits of companies included on an equity basis, net income from extraordinary activities, and the cumulative effect of a change in the method of accounting and also translation adjustments from the report on the change in equity for companies included on an equity basis.

c Total income is defined as net income plus the share of minority interests and translation adjustments imputed to equity.

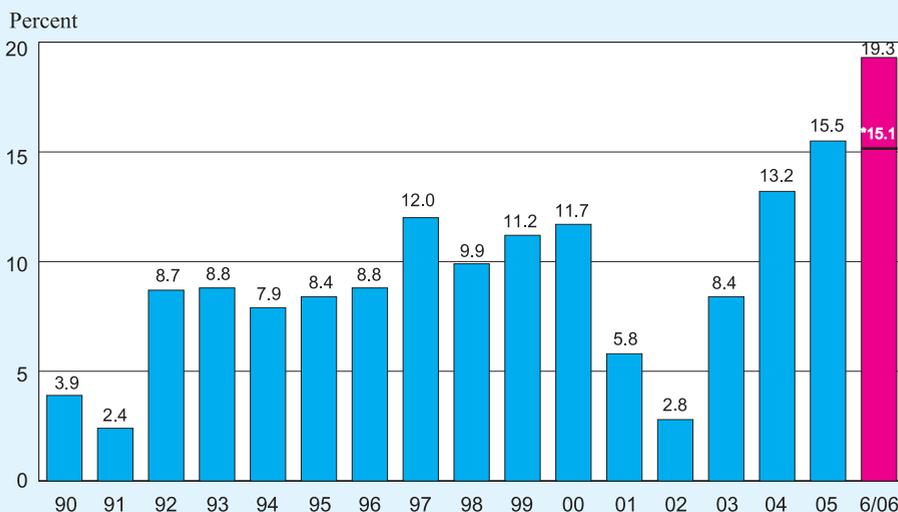
d Equity and minority interests at beginning of year plus issues according to time of issue minus dividends paid, according to time paid.

e Calculated as profit to the end of the year divided by equity at the end of the previous year.

SOURCE: Based on published financial statements.

ROE of sales carried out as part of the Bachar reform of the capital market, in the first half of 2006 only seven transactions totaling NIS 1.8 billion in five commercial banks were performed: Hapoalim, Discount, Mizrahi-Tefahot, Union and Jerusalem. These transactions yielded extraordinary net income of NIS 969 million, which constituted 35.3 percent, on average, of those banks' net profit.⁸ If the profit on the sales by the largest five banking subsidiaries is deducted, the ROE in the first half of 2006 is reduced on average from 19.3 percent⁹ to 15.14 percent (Figure 1.18).

Figure 1.18
After-Tax Return on Equity (ROE), the Five Major Banking Groups,
1990 to June 2006



* Return on equity excluding income from the sale of provident and mutual funds following the Bachar reforms.
 SOURCE: Based on published financial reports.

In 2005, as in 2004, the rise in profits of the five major banking groups derived mainly from the increase in net interest income before loan loss provision and from the decline in loan loss provision. On the other hand, the rise in operating expenses was more than twice the rise in non-interest income (NIS 2.3 billion and NIS 1.1 billion respectively),

⁸ The effect of these transactions on the banks' net profit in the first half of 2006 was as follows: sale of the P.K.N, Bank Yahav and Bank Massad mutual funds contributed 28.5 percent to the net profit of the Hapoalim group; the sale of shares in Ilanot Discount contributed 57.7 percent to the net profit of the Discount group; the sale of the Emda fund contributed 37.7 percent of the Mizrahi-Tefahot group net profit; the sale of A.K.N. mutual fund and Union Provident Funds contributed 55.3 percent of Union Bank's net profit, and the sale of Jerusalem Funds Management contributed 43.6 percent to the Bank of Jerusalem's net profit. For details of the purchasers see Box 1 below.

⁹ Hapoalim, 16.89 percent vis-à-vis 23.98 percent; Discount, 5.68 percent vis-à-vis 13.66 percent; Mizrahi-Tefahot, 9.27 percent vis-à-vis 15.07 percent.

and the extent of operating expenses had a negative effect on profits (Table 1.10). The exceptional increase in operating expenses in 2005 was due to the significant increase in salary and related expenses in Leumi and Discount.¹⁰

The tax provision of the five major banking groups in 2005 was 42.5 percent of pre-tax profit, a decline of 1.2 percentage points from the provision in 2004. This is explained in part by the reduction in the statutory tax rate from 44.5 in 2004 to 43.6 percent in 2005.¹¹

The contribution of companies included in the group's equity to net operating profits was the same as in 2004, at about NIS 660 million.¹²

2. INCOME AND EXPENSES

a. Net interest income before loan-loss provision

The upward trend in net interest income before loan-loss provision in the five major banking groups continued in 2005, with an increase of 7.6 percent (compared with a rise of 8.2 percent in 2004) to a total of about NIS 21.5 billion. As in 2004, net interest income rose in each of the five groups, albeit with a considerable difference between the large groups and the medium-sized ones. In Leumi, Discount and Hapoalim it increased moderately, while in the First International and Mizrahi it increased relatively steeply (Table 1.10).

The growth in net interest income derived mainly from the 5.8 percent increase in the banking groups' assets, to a total of about NIS 1,100 billion. This was partially offset by the price effect resulting from the contraction of the weighted interest-rate spread

¹⁰ A rise of NIS 582 million in Bank Leumi expenditure, most of which (NIS 380 million) was due to the rise in salary and related expenses (compared with a decline of about NIS 122 million in operating and other expenses in 2004), and an exceptional increase of NIS 711 million in the expenditure of the Discount group much of which derived from the NIS 380 million rise in salaries and related expenses (of which NIS 196 related to early retirements), and the provision of NIS 120 million for the agreement signed by Israel Discount Bank of New York with the US supervisory authorities.

¹¹ On July 25th 2005 the Knesset passed the Amendment to the Income Tax Order (No. 147 and the Temporary Provision) Law, 5765–2005, which gradually reduces company tax from 34 percent in 2005 to 25 percent from 2010. Banks, as financial institutions for purposes of the Value Added Tax Law, pay profit tax at a rate of 17 percent, which constitutes an expense for companies tax, so that reducing companies tax will result in a smaller tax reduction for banks, so that in 2005 the total tax rate was 43.59 percent, in 2006 the rate will be 41.03 percent, in 2007, 39.32 percent, in 2008, 37.61, in 2009, 36.75 percent, and from 2010, 35.9 percent.

¹² There is however marked variation between the five large banking groups. In the Discount group, income from these companies rose by some 30 percent, due to the group's share of the profit of the First International and of Harel Insurance Investments; in Leumi, they declined by about 8 percent, due to the fall in the profit of Migdal Insurance and Financial Holdings and of Africa Israel which was partly offset by increased profits of Israel Corp. In the Mizrahi and First International groups the companies included under an equity method made minor contributions to profit.

by 0.02 of a percentage point, from 1.53 percent in 2004 to 1.51 percent in 2005 (Table 1.11).

The main contribution to net interest income came from domestic activity in foreign currency, with a rise of about NIS 1.6 billion, due to the positive effects of both price and quantity (Table 1.12 and Figure 1.19). In 2005 the weighted interest-rate spread in foreign-currency activity abroad declined from 1.64 percent to 0.74 percent. This drop occurred despite the rise in the rate of income from assets (mainly credit to the public) and stemmed from a sharp rise in expenses on deposits of the public.¹³

In domestic foreign-currency activity, however, the weighted interest-rate spread widened a little, because the rate of income from assets rose more quickly than the rate of expenses on liabilities, mainly on deposits. Although Libor is common to both the market in Israel and the market abroad, it seems that the banks' reacted more moderately in Israel to the possibility of losing customers because of the rise in the rate than they did abroad. The reason for this may be that in Israel there are other indexation segments, so that the potential loss of customers due to a rise in interest in the economy is lower than abroad.

Another positive contribution, of about NIS 630 million, to the rise in net interest income derived from activity in the local-currency unindexed segment, in which the positive quantity effect was stronger than the negative price effect, which slightly reduced the increase (Table 1.11). It appears that the expansion of activity in this segment may be due to the fact that it is less exposed to non-bank competition.

¹³ It is presumed that this is explained by asymmetry of interest-rate fluctuations: in periods of rising interest (3-month Libor rose from 2.56 percent in January 2005 to 4.53 percent in December 2005), especially in such short periods, the banks are faced with a potential liquidity problem, and must react quickly by raising the interest on deposits to prevent a run on deposits and their diversion to alternatives. In the credit market, on the other hand, the interest rate is adjusted more slowly, as the banks tend to check more thoroughly whether the changes in interest in the market are temporary or longer term. This is because of concern that raising the interest on credit may adversely affect borrowers repayment ability, and that they (the banks) will themselves have to bear part of the burden and incur unexpected losses, including restructuring credit under less favorable conditions. It may be that when interest is rising, customers with risky projects may join the ranks of borrowers, while customers financing projects with lower risks and rates of return may have to stop taking credit at such high costs, as they cannot meet the repayments. Thus, raising the interest on the credit portfolio increases the probability of reducing its quality, and in the short term is not worthwhile for the banks. In the long term, when it becomes clear to the banks that the rise in interest is not temporary, they raise the interest on their credit to avoid losses deriving from a rise in the cost of their sources without a corresponding rise in the return on their uses. This effect is even more pronounced when interest rises steeply, as happened to the Libor in 2005.

Another possible explanation for the contraction of the interest-rate spread at times of rising interest rates is the difference between the average duration of assets and liabilities. It is generally accepted that the average duration of deposits is shorter than that of assets, so that when interest rates are rising the value of assets falls faster than that of liabilities, resulting in erosion of the weighted interest-rate spread. For a fuller discussion of this topic, see the book by David Ruthenberg (2002), "Bank Management in Israel," pp. 101–104.

Table 1.11
Interest Income and Financing Costs (including Derivatives) by Indexation Base, the Five Major Banks, 2004–05

	Assets ^a			Liabilities ^b			
	Interest income (1)	Average annual balance (2)	Rate of income from assets (3)=(1)/(2)	Financing costs (4)	Average annual balance (5)	Financing costs' share of liabilities (6)=(5)/(4)	Weighted interest spread (7)=(3)-(6)
Indexed	12,372	194,208	6.37	9,047	171,685	5.27	1.10
Unindexed	18,041	293,500	6.15	9,940	284,991	3.49	2.66
Foreign currency, local	14,194	409,398	3.47	10,864	403,563	2.69	0.78
Foreign currency, abroad	4,664	143,912	3.24	2,330	145,603	1.60	1.64
Total	49,271	1,041,018	4.73	32,181	1,005,842	3.20	1.53
2005							
	Assets ^a			Liabilities ^b			
	Interest income (1)	Average annual balance (2)	Rate of income from assets (3)=(1)/(2)	Financing costs (4)	Average annual balance (5)	Financing costs' share of liabilities (6)=(5)/(4)	Weighted interest spread (7)=(3)-(6)
Indexed	14,657	186,436	7.86	11,194	164,826	6.79	1.07
Unindexed	18,227	327,232	5.57	9,498	310,378	3.06	2.51
Foreign currency, local	26,387	432,140	6.11	21,402	433,835	4.93	1.17
Foreign currency, abroad	10,822	154,409	7.01	9,443	150,564	6.27	0.74
Total	70,093	1,100,217	6.37	51,537	1,059,603	4.86	1.51

^a Assets include credit to the public, bonds held to maturity, bonds available for sale, tradable bonds, credit to the government, cash, deposits with the Bank of Israel, and deposits with other banks.

^b Liabilities include the public's deposits, the government's deposits, and the banks' and other deposits.
SOURCE: Published financial statements.

Table 1.12**Breakdown of Profits from Financial Activities before Loan-Loss Provision, by Type of Indexation, The Five Major Banking Groups, 2004–05**

	2004	2005	Change relative to 2004	Percentage change relative to 2004
	(NIS million, current prices)			(percent)
Net Income^a by type of indexation (including derivatives)				
Local currency, unindexed	8,101	8,729	628	7.8
Local currency, CPI-indexed	3,325	3,463	138	4.2
Foreign currency - domestic activity	3,351	4,985	1,634	48.8
1. Total income from indexation derivatives	14,777	17,177	2,400	16.2
Other financial income				
Commissions on transactions	747	770	23	3.1
Other net financial income	1,714	1,980	266	15.5
<i>of which</i> Interest income on problem debts previously not recorded	832	1,002	170	20.4
<i>of which</i> Profits from the sale and valuation of bonds ^b	524	287	-237	-45.2
2. Total other financial income	2,461	2,750	289	11.7
3. Options and other derivatives	415	205	-210	-50.6
Profit from financial activities before loan-loss provision (1+2+3)	17,653	20,132	2,479	14.0

^a Net: income from assets minus expenses on liabilities.

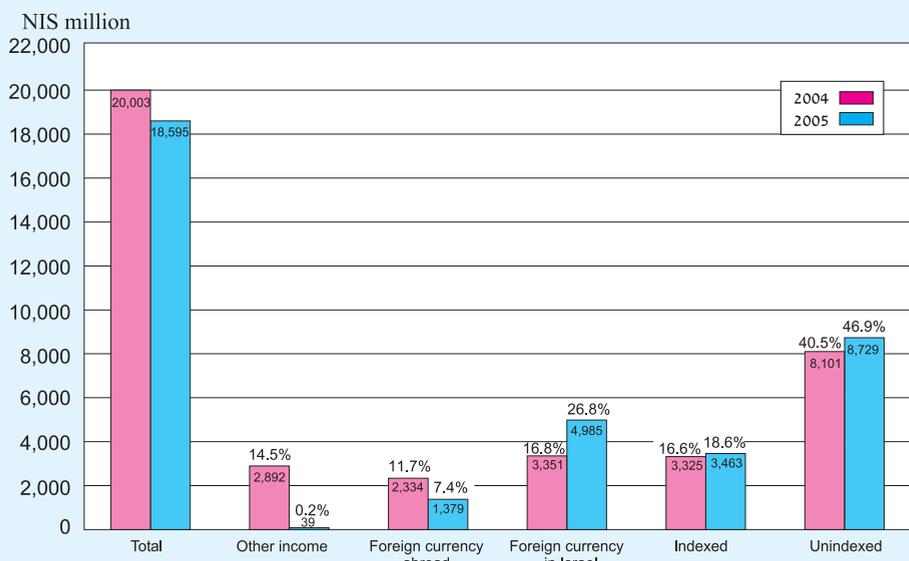
^b Including profits/losses from the valuation and sale of tradable bonds and the sale of bonds available for sale and bonds held until maturity.

SOURCE: Published financial statements.

Households' and small and medium businesses' rising demand for credit was met by the banks and directed towards this, the local-currency unindexed, segment. In 2005, as in 2004, there was a large difference between the interest-rate spread for households and that for the business sector. This probably reflects the lack of alternative credit sources for households. Support for this contention can be found in the market power index¹⁴ of the five major banking groups in the local-currency unindexed segment, which shows that the market power exercised by the banks over households is significantly greater than that exercised over businesses.

¹⁴ The market power of firm j is defined as the relative deviation of the price of a product from its marginal cost. The market power of the industry in its entirety (M) is calculated as the weighted average (in the relative size of the firms) of the market power of the individual banking firms: $M = \sum_{j=1}^n \left[\frac{P_j - C_j}{P_j} \right] \frac{Y_j}{Y}$ where P_j is the price of bank credit of bank j ; Y_j is the amount of credit to the public of bank j ; Y is the amount of credit in the system; and n is the number of banking firms in the industry.

Figure 1.19
The Contribution of the Various Indexation Segments to Profit of the Five Major Banking Groups, 2004 and 2005
 (at current prices)



The numbers above the columns show the share (in percent) of the segment in total net interest income, and the numbers within the columns show profits.

SOURCE: Based on published financial statements.

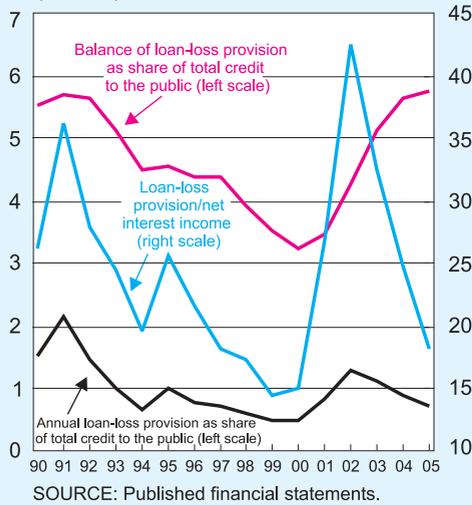
In contrast to the above, the increase of some NIS 140 million in the contribution of the local-currency indexed segment to net interest income, in which there was a marked change in the weighted interest-rate spread (it fell), did not derive from an expansion of activity,¹⁵ as rising competition from non-bank entities acted to dampen the public's demand for indexed credit. This segment's positive contribution to net interest income was the result of the 2.7 percent rise in the CPI in 2005.

b. Loan-loss provision

The annual loan-loss provision of the five major banking groups fell by about NIS 1 billion in 2005, to NIS 3.9 billion, a reduction of about 20 percent (Table 1.13), a rate of 0.71 percent of total balance-sheet credit. The decline in the rate in 2005 continued the trend that started in 2003, after three years of steep increases which reached a peak in 2002 with a rate of 1.31 percent. Unlike in 2004, when the rate of provision fell in three of the five major groups (Hapoalim, Leumi and the First International), in 2005 the rate went down in all five of them (Table 1.13).

¹⁵ Credit to the public in the CPI-indexed segment in the five major banking groups grew by 4.2 percent, but the average annual balances, which are relevant to interest income, contracted during 2005.

Figure 1.20
Loan-Loss Provision in the Five Major Banking Groups, 1990-2005
 (Percent)



The balance of loan-loss provision totaled NIS 31.9 billion (Table 1.13), a rate of cover of 5.76 percent of total credit to the public; this is an improvement compared with the rates of 5.65 percent in 2004 and 5.10 percent in 2003 (Figure 1.20). The cover rate of the balance of loan-loss provision to problem loans was 37 percent in 2005 (Table 1.17), and was the outcome of a rise in the balance of the provision for doubtful debts and a decline in the balance of problem loans (Table 1.18).

Most of the rise of the balance of loan-loss provision in 2005 was due to the increase of NIS 1.6 billion (5.7 percent) in the balance of the specific loan-loss provision made by the banks in accordance with the repayment ability and collateral of the various borrowers.

Table 1.13
Components of the Loan-Loss Provision for the Five Major Banking Groups, 2003-05
 (NIS million, current prices)

	2003 ^a			2004			2005		
	The specific provision	The general and additional provision	Total	The specific provision	The general and additional provision	Total	The specific provision	The general and additional provision	Total
Beginning-of-year balance of the provision	20,265	3,269	23,534	23,972	3,371	27,343	26,947	3,387	30,334
Additions to the provision during the accounting year	6,941	172	7,113	6,574	100	6,674	5,830	129	5,959
Reduction of the provision	-976	-95	-1,071	-1,578	-88	-1,666	-1,787	-131	-1,918
Collection of debts written off in previous years	-62	0	-62	-50	0	-50	-88	0	-88
Amount entered in the profit and loss statement	5,903	77	5,980	4,946	12	4,958	3,955	-2	3,953
Debts written off	-2,440	0	-2,440	-2,009	0	-2,009	-2,382	0	-2,382
Erosion and adjustment of balances	188	0	188	69	0	69	4	0	4
End-of-year balance of provision	23,916	3,346	27,262	26,978	3,383	30,361	28,524	3,385	31,909

^a The differences between the end-of-year 2002 balances and the beginning-of-year 2003 balances are the result of the increase of the provisions at Bank Hapoalim due to companies that were consolidated for the first time.
 SOURCE: Published financial statements.

The general and additional loan-loss provisions as specified in the directives of the Supervisor of Banks according to the risk profile of the bank credit portfolio did not change in 2005. This stability can be explained in part by decline in the share of problem loans in total credit (from 10.9 percent in 2004 to 9.8 percent in 2005), which resulted from the continued improvement in businesses' repayment ability (Table 1.17).

c. Non-interest income

The continued improvement in Israel's economy in 2005 boosted the upward trend in non-interest and other income in the five major banking groups, a trend that was renewed in 2002 after a reduction of 3.6 percent in 2001. In 2005 non-interest and other income rose by 9.6 percent (about NIS 1.1 billion) from the 2004 level, to NIS 12.8 billion (Table 1.14).

Non-interest income in all five banking groups rose by between 8 percent and 9 percent, except for the First International, which posted an exceptional 22 percent jump due the inclusion of the activity of Ubank in the group's financial statements for the first time since its purchase.

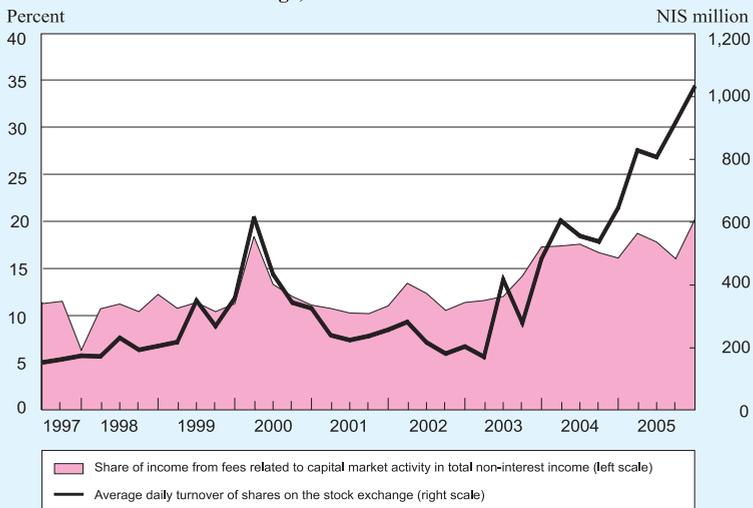
The 4.2 percent rise in non-interest income from the provision of regular banking services came mainly from the continued increase in income from charges on the use of credit cards (an increase of about 10.6 percent). This was due mainly to the increase of about 9 percent in the number of credit card transactions and an increase of 9.9 percent in their value. The number of transactions reached some 490 million, and their value, NIS 118 billion (Table 1.7).

Other elements that increased the income from regular banking services include the income from handling credit and from drawing up contracts (which increased by about 9.3 percent), and income from foreign-currency transactions and special services (up by about 9.4 percent). Income from account management fees and from computerized services, the provision of information, certificates and confirmations fell, due to the increase in competition between the banks in the area of fees and from credit card companies that offer non-bank credit.

The rise in income from capital market activities in 2005 resulted from the increase in share trading and in the extent of activity on the Tel Aviv Stock Exchange (Figures 1.21 and 1.22), which were affected by the growth trend in the economy, by the sharp rise in issues of securities (shares and bonds), and by the increase in custody fee income (due to the rise in value of the public's asset portfolio and to its distribution, as explained in this chapter (Table 1.9). The growth in income from provident fund and mutual fund management fees in 2005 was due to the increase in customers' assets.

The Bachar reform that obliged the banks to sell their entire holdings in provident funds and mutual funds will remove these management fees as a source of income for the banks. In their place will come income deriving from the soon-to-be-issued permit for banks to engage in consultancy on and distribution of, and in the longer term, the sale of life insurance and pension schemes.

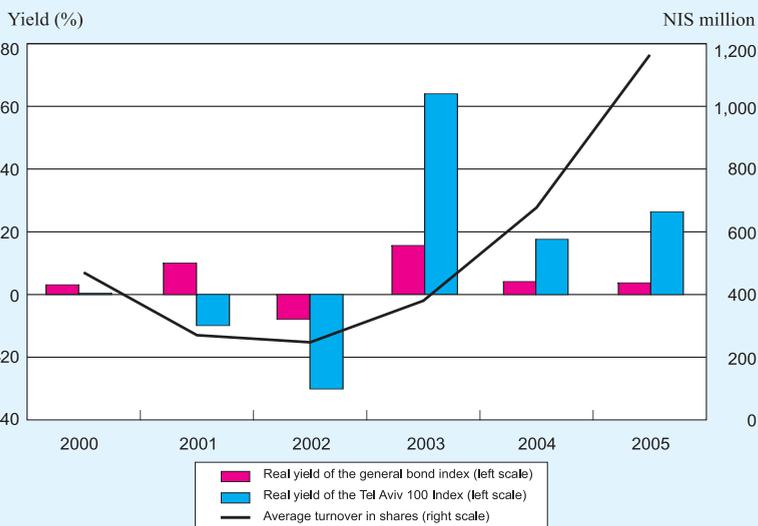
Figure 1.21
Share of Income from Capital-Market Activity of the Five Major Banks in Total Non-Interest Income, and the Average Daily Turnover in Shares on the Tel Aviv Stock Exchange, June 1997 to December 2005



The correlation coefficient between the share of income from capital-market activity in non-interest income and the average daily turnover of shares on the stock exchange is 0.79.

SOURCE: Reports to the Supervisor of Banks and the Tel Aviv Stock Exchange.

Figure 1.22
Real Annual Yield of the Tel Aviv 100 Index, the General Bond Price Index and Average Daily Turnover in Shares 2000-05



SOURCE: Based on data from the Tel Aviv Stock Exchange

Table 1.14

Non-Interest Income and Operating Expenses of the Five Major Banking Groups, 2003–05

	Amount			Distribution			Year-on-year change	
	2003	2004	2005	2003	2004	2005	2004	2005
I. Non-interest income								
Income from banking services			(NIS million, at current prices)	(percent)			(percent)	
Ledger fees	1,461	1,483	1,470	13.6	12.7	11.4	1.5	-0.9
Payment services	1,848	1,901	1,931	17.2	16.2	15.0	2.9	1.6
Credit cards	1,748	1,925	2,129	16.3	16.4	16.6	10.1	10.6
Credit services and contracts	741	793	867	6.9	6.8	6.8	7.0	9.3
Computerized services, data and approvals	213	216	197	2.0	1.8	1.5	1.4	-8.8
Foreign trade and special services	352	383	419	3.3	3.3	3.3	8.8	9.4
Other commissions ^b	897	845	852	8.3	7.2	6.6	-5.8	0.8
Total income from banking services	7,260	7,546	7,865	67.5	64.4	61.2	3.9	4.2
Income from activity in the capital market								
From activity in securities ^a	1,361	1,752	2,128	12.7	15.0	16.6	28.7	21.5
Provident and mutual funds fees	1,438	1,814	2,136	13.4	15.5	16.6	26.1	17.8
Provident fund fees	874	875	946	8.1	7.5	7.4	0.1	8.1
Mutual fund fees	564	939	1,190	5.2	8.0	9.3	66.5	26.7
Total income from activity in the capital market	2,799	3,566	4,264	26.0	30.4	33.2	27.4	19.6
Other income								
Profit from compensation funds	455	138	372	4.2	1.2	2.9	-69.7	169.6
Profit from the sale of shares ^c	35	273	131	0.3	2.3	1.0	680.0	-52.0
Others ^d	203	189	210	1.9	1.6	1.6	-6.9	11.1
Total other income	693	600	713	6.4	5.1	5.6	-13.4	18.8
Total operating fees^e	8,621	9,298	9,993	-	-	-	7.9	7.5
Total non-interest income	10,752	11,712	12,842	100.0	100.0	100.0	8.9	9.6

(cont'd)

Table 1.14 (Cont'd)
Non-Interest Income and Operating Expenses of the Five Major Banking Groups, 2003–05

	Amount			Distribution			Year-on-year change	
	2003	2004	2005	2003	2004	2005	2004	2005
2. Operating expenses								
Salaries and related expenses ^f	10,826	11,409	12,646	60.6	60.3	59.7	5.4	10.8
Maintenance of buildings	3,343	3,391	3,663	18.7	17.9	17.3	1.4	8.0
Other expenses	3,695	4,130	4,890	20.7	21.8	23.1	11.8	18.4
Marketing and advertising	539	596	660	3.0	3.1	3.1	10.6	10.7
Computer expenses	556	665	866	3.1	3.5	4.1	19.6	30.2
Communications	500	504	554	2.8	2.7	2.6	0.8	9.9
Insurance	215	197	168	1.2	1.0	0.8	-8.4	-14.7
Office	233	238	267	1.3	1.3	1.3	2.1	12.2
Professional services	521	599	716	2.9	3.2	3.4	15.0	19.5
Total operating expenses	17,864	18,930	21,199	100.0	100.0	100.0	6.0	12.0
Operating coverage rates^g (percent)	60.2	61.9	60.6					

^a Including income from the activity of customers in securities, from financial instruments, custody fees, underwriting and distribution of securities.

^b Including primarily collection spreads and commissions on credit from the Ministry of Finance, handling fees for inheritances and estates, rental of safes, etc.

^c Including income from the sale of shares available for sale, from the adjustment of the fair value of tradable shares and dividends from shares available for sale.

^d Including profit from the sale of assets that were received to pay off debts and rental of buildings that are not in use by the bank, dividends not from subsidiary/affiliated companies, etc.

^e Including total income from banking services and activity in securities.

^f Including payroll tax, compensation, benefits, pension and National Insurance.

^g The ratio of non-interest and other income to operating and other expenses.

SOURCE: Reports to the Supervisor of Banks.

The Effects of the Bachar Reforms on the Banking System's Business Results

In August 2005, the "Law For Increasing Competition and Reducing Concentration and Conflicts of Interest in the Israeli Capital Market (Legislative Amendment), 5765–2005" ("the Bachar law") was passed. This law was based on the recommendations of an inter-ministerial working committee formed for the purpose of formulating recommendations on the activities required in order to consolidate a competitive structure in the Israeli capital market ("the Bachar Committee recommendations"). The team was appointed by the Minister of Finance in April 2004, and the Bank of Israel was represented on the committee by the Deputy Governor and the Supervisor of Banks. In order to reduce market concentration and to minimize conflicts of interest, the banks were obliged to sell in full their holdings in provident funds and mutual funds.¹ (For further details on this topic see the Annual Survey 2004).

This new legislation is expected to result in changes in activities of the banking system as well as in the financial system generally. Due to the law, the public's assets in provident funds and mutual funds, which until now had been managed through management companies owned by the banks, will pass to non-bank financial parties, as described below, such that all long-term savings—pension funds, provident funds and life insurance—will be managed by these parties.² Nevertheless the banks will still be able to conduct distribution and advice activity for such assets. At the same time banks will be allowed, as stated, to provide advice and distribution of pension funds,³ and in the future life insurance products too. In these conditions competition is expected to increase, both between the banks themselves as well as between the banks and other financial institutions,

¹ The entry of a bank into the field of consulting and sale of provident and pension products was conditional on the sale of the bank's holdings in provident funds and insurance companies, and, in the case of the large banks, of mutual funds too. The entry of the small banks into the field of consulting and sale of life insurance products was conditional on their sale of provident funds, mutual funds and insurance holdings, and would be permissible from 2010. The large banks would be allowed to offer consultancy and sale of life insurance products five years after the sale of their holdings in provident funds, mutual funds and insurance companies. The Bachar law defines large banks as those whose equity is larger than NIS 10 billion (Hapoalim, and Leumi); and these large banks must, according to this law, sell their provident funds and mutual funds within three and four years respectively, while the small banks must sell within six and eight years respectively.

² These three frameworks—pension, provident and life insurance—managed savings funds totaling approximately NIS 570 billion in December 2005.

³ To receive a license to operate in pension consultancy, a banking corporation must hold no more than 5 percent of an insurer or 10 percent of an insurer's holding corporation or an insurance agency other than agencies that concentrate specifically on life insurance and mortgaged assets.

particularly insurance companies, and others such as investment companies, private brokerages (local and foreign) which are expected to provide an alternative to banking financial mediation. It must be stressed that the developing trend of alternative sources of business credit outside of the banking system in Israel has been influenced by additional reforms in recent years and the returns generated in the capital market, among them: a) an increase in the non-directed tradable share of long-term savings and the increased involvement of local institutional investors and foreign banks from abroad in the market for tradable capital. This is due to the government's gradual withdrawal from the pension and provident market by ceasing to issue earmarked bonds, as well as due to the removal of the quantitative limits on provident funds' investments in tradable assets;⁴ b) an increase in the number of long-term savings institutions (provident funds, advanced training funds and insurance companies) directing their investments to the capital market, to pension funds, to non-profit organizations and to investment bodies from abroad; c) a sharp fall in the quantity and composition of government bond issues, due to the sharp drop in the budget deficit and the government's preference to issue bonds abroad;⁵ d) bringing the tax rate on gains on securities investments into line; at the same time, bank managements in recent years have toughened their criteria for extending business credit. All these processes accelerated the development of an alternative market to bank credit, and the business sector began to find the financing they needed outside of the banking system. This diversifies the sources of funding open to firms and reduces their dependence on bank credit, diminishes the banks' exposure to borrowers with alternatives in the capital market, reduces the banks' dominance in the financial system and contributes to the development and the deepening of the capital market.

The deposit market is also expected to see competition develop, as the mutual funds are able to offer similar investments to bank deposits, such as the Money Market Mutual Funds in the US, which permit the writing of checks against sums invested in the fund.

Following the introduction of the Bachar law, the banks reached agreement in principal with financial non-bank intermediaries on the sale of their activities in provident funds, advanced training funds and mutual funds management companies which they owned. Within a year, agreements for sale were signed on assets worth some NIS 149 billion, most of which to the five largest insurance groups in Israel and to two foreign investment funds, Markstone Fund and York

⁴ Amendment to the Income Tax Ordinance (Rules for Approval and Management of Provident Funds), 5724–1964, amendment 5762.

⁵ Net borrowing (total borrowing less redemptions) by the Ministry of Finance in the capital market in 2005 totaled only NIS 5 billion, one quarter of borrowing in each of the previous two years.

Fund, for NIS 7.1 billion. (For the principal agreements on the purchase of provident institutions and mutual fund management companies in Israel see table in Box 1). By October 2006, agreements for sale had been signed on 99 percent of the mutual funds held by the banks (in terms of value of funds) and on 45 percent of the provident funds and advanced training funds.

Most of the agreements conditioned their fulfillment on the signing of agreements to provide operating services for the provident funds and mutual funds and the signing of distribution agreements in exchange for fees at the maximum level set by the regulations.⁶ In 2005 the banking system's income from management fees on all their funds in the market totaled approximately NIS 2.1 billion, about 16 percent of their total operating revenues.⁷ In addition to the current income from operating services of the provident funds and the income from distributing mutual and provident funds, the banks are expected, after selling their holdings above the 10 percent limit in insurance companies,⁸ to market pension products. Apart from the one-off income of about NIS 7 billion from the sale of 99 percent of the mutual funds (in value) and 45 percent of the provident funds, the banks expect an annual income from distributing and operating these funds, a one-time income from the sale of the rest of these assets held by the banks as well as additional current income from distributing insurance and pension products.

In conclusion, the law is an additional step in consolidating a more competitive financial system, in which several large financial intermediaries (banks, insurance companies, other financial entities) will operate, and which will compete among themselves over the supply of financial goods and services to the public. In this framework the banks will sell pension and insurance products, taking advantage of their efficiency in providing financial services, while insurance companies and other financial entities will enter the banks' traditional fields of activity, mainly

⁶ Regarding mutual funds, the regulations set a fee of 0.25 percent for funds investing mainly in short-term investments and risk, 0.8 percent for funds investing mainly in shares, and 0.4 percent for all other funds for all fund units managed by the fund manager held via the distributor. The regulations also state that banks shall not be subject to the regulation that states that in calculating the number of fund units subject to distribution fees they shall not include units purchased prior to the distribution agreement reached. Regarding the banks, it was determined that units bought in the past shall also be liable to distribution fees. Regarding provident funds, a distribution fee of 0.25 percent was set for deals that a consultant will conduct or for continued membership. In addition, in regulating the field of financial consultancy, as set by the Ministry of Finance, the provision of managerial or operating services to an institution by a financial consultant, the maximum rate of compensation is 0.1 percent of the value of the assets in the provident funds sold.

⁷ There are no data in the financial reports on the fees charged by the banks on these parties, but most of their operating revenues (about 90 percent) which stood at NIS 2.1 billion in 2005 came from management fees.

⁸ As of today: Leumi – 20 percent in Migdal; Hapoalim – 14.2 percent in Clal; Discount – 15.9 percent in Harel.

capital market activities and credit. Therefore, from the regulatory standpoint of the supervision and enforcement of bank and non-bank financial entities, a financial institution will have to be redefined while drawing up an infrastructure as consistent and uniform as possible concerning regulation, such that the instructions in the field of managing the public's assets will be consistent for all financial intermediaries, while taking into consideration the special characteristics of different assets.

d. Operating and other expenses

Despite the improvement in operating income this year, operating expenses increased faster than income, and totaled approximately NIS 21.2 billion, compared to NIS 18.9 billion in 2004. Most of this growth in operating and other expenses stemmed from a rise in 'other expenses'. For example, the computing item this year rose by more than 30 percent as a result of large investments in systems development such as RTGS, and the systems for implementing the Basel II accord, the extension of the bank business day and the money laundering prohibition. The growth in the expenses component for personnel¹⁶ (10.8 percent), which constitute 60 percent of the total operating expenses (Table 1.14), stemmed mostly from a significant rise in direct wage expenses (excluding related expenses) further to a rise in this item in the preceding year (Table 1.15).¹⁷ The Israel Discount group accounted for 23 percent of all direct wage expenses of the five largest banking groups, apparently due to the implementation of a voluntary retirement plan for its workers.

The increase in expenses for voluntary retirement did not affect all banking groups; Leumi and Discount—who together accounted for 82.5 percent of this item among the large five groups—registered a sharp rise in this expense, both as part of the sale of control (transfer of control from state ownership to private ownership) and as part of their efficiency-drive strategies. The Hapoalim, Mizrahi and First International groups saw a reduction in this expenditure item year-on-year.

The number of employee posts in the banking system increased this year by 3.7 percent (some 39,569 positions) after three years of a decline in the number of employee posts, as a result of the encouragement of early retirement and employee dismissals as

¹⁶ This includes total wages, benefits due to share issues to workers, severance pay, other benefits, pensions, advanced training funds and vacation, National Insurance contributions, employers' tax and wage tax, other associated expenses, top up of reserves in respect of associated expenses following changes in wage in the year of account and voluntary retirement expenses.

¹⁷ Wage expenses in 2005 include for the first time wage tax expenses in respect of changes in the definition of wages in the Value Added Taxation Law.

Table 1.15
Salaries and Related Expenses of the Five Major Banking Groups, 1997-2005 (at current prices)^a

	Average number of posts ^b	Salaries		Related expenses ^c		Salaries and related expenses	
		Total	Per post	Total	Per post	Total	Per post
		(NIS million)	(NIS thousand)	(NIS million)	(NIS thousand)	(NIS million)	(NIS thousand)
1997	38,180	6,294	165	2,888	76	9,182	241
1998	38,230	6,341	166	2,955	77	9,296	243
1999	38,248	6,607	173	3,063	80	9,669	253
2000	39,251	7,220	184	3,557	91	10,777	275
2001	39,753	7,231	182	3,560	90	10,791	271
2002	39,531	6,819	172	3,976	101	10,795	273
2003	38,427	7,260	189	3,566	93	10,826	282
2004	38,170	7,732	203	3,677	96	11,409	299
2005	39,569	8,530	216	4,116	104	12,646	320
Change from Previous Year (percent)							
1998	0.1	0.7	0.6	2.3	2.2	1.2	1.1
1999	0.0	4.2	4.1	3.6	3.6	4.0	4.0
2000	2.6	9.3	6.5	16.1	13.2	11.5	8.6
2001	1.3	0.1	-1.1	0.1	-1.2	0.1	-1.1
2002	-0.6	-5.7	-5.2	11.7	12.3	0.0	0.6
2003	-2.8	6.5	9.5	-10.3	-7.7	0.3	3.2
2004	-0.7	6.5	7.2	3.1	3.8	5.4	6.1
2005	3.7	10.3	6.4	11.9	8.0	10.8	6.9

^a Up until 2002, the amounts are adjusted for inflation according to the December 2003 index.

^b The number of posts includes those in subsidiaries abroad and in the consolidated companies, translation of the cost of overtime and the budgets for outside workers required to adjust for changes in the regular manpower and to assimilate projects.

^c Includes mainly severance pay, benefits, advanced study fund, pension, annual leave, National Insurance and payroll tax, other related expenses, voluntary retirement expenses, and distribution of options to staff.

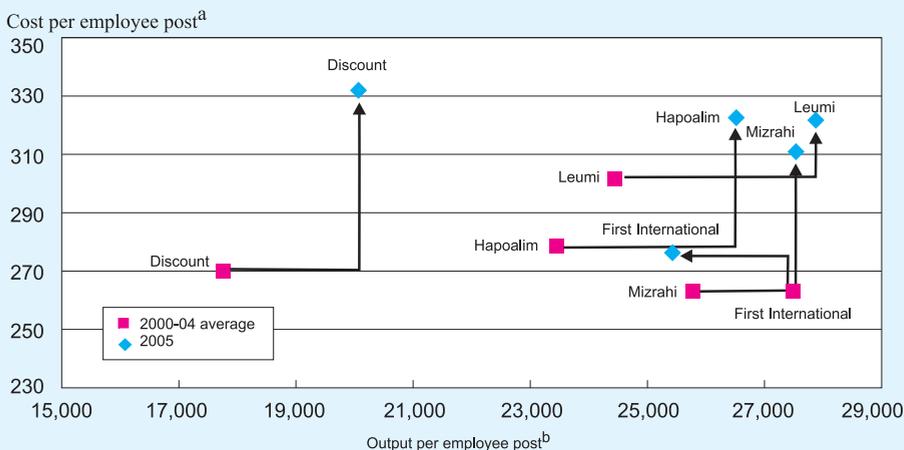
Source: Published financial statements and reports to the Supervisor of the Banks.

part of the efficiency drive (Table 1.15). In contrast to the previous year, the increase in number of employee posts (on a monthly average basis¹⁸) this year encompassed all the five banking groups. At First International the rise reflected the addition of Ubank (formerly Investec) workers into the fold, following the merger with the First International group.

¹⁸ Number of employee posts at the end of the year (at 31 December 2005) was 1400 higher than at the end of the preceding year. The major increase was in the First International Bank of Israel group which added 360 posts.

In recent years, the banks have placed an emphasis on a match between worker remuneration and the bank's profitability in general and the average employee productivity in particular. In analyzing the development of an index of output per employee¹⁹ relative to the cost of employing the worker in 2005 compared to the average in the years 2000 to 2004, this showed a positive relationship for all banking groups, except for the First International Bank group which showed a negative relationship; the rate of growth in the number of its employees was higher than the addition to its assets and caused a drop in cost per employee post. This was due apparently to the addition of Ubank data to the group's financial reports against the background of the latter's merger with the First International group (Figure 1.23).

Figure 1.23
Cost^a and Output^b per Employee Post in the Five Major Banking Groups, 2005 compared to the 2000-04 average
 (NIS thousand at current prices)



	Rate of change in output per employee post in 2005 compared to 2000-04 average (A)	Rate of change in cost per employee post in 2005 compared to 2000-04 average (B)	Ratio of rate of change in cost to rate of change in output, per employee post, in 2005 compared to 2000-04 average $C=(1+A)/(1+B)$
Hapoalim	13.10	15.9	1.025
Leumi	14.02	6.7	0.935
Discount	13.17	22.3	1.081
First International	-7.38	5.5	1.139
Mizrahi-Tefahot	6.85	18.2	1.106

^a Salaries and related expenses divided by number of employee posts including those in subsidiaries abroad; includes a translation of the cost of overtime and a budget for staff from manpower companies.

^b Total balance-sheet assets of the banking group plus credit equivalent value of off-balance-sheet assets.
 SOURCE: Based on published financial statements.

¹⁹ Output per employee, as measured by total balance-sheet assets and the equivalent credit value of non-balance-sheet assets divided by the number of employee posts, is used as an index of average employee productivity.

The large rise in wages in the banking system in recent years is particularly striking when compared with other sectors in the economy; the index of real wages per employee post in the banking, insurance and pension industries surged by 13.0 percent compared to 2003 and in comparison with the index of wages per employee post in the economy and in the business sector, which rose by 3.2 percent and 3.6 percent respectively (Figure 1.24). Furthermore, in analyzing the employee wage distribution in the banking system, the trend continued, which began in 1999, of a greater rate of employees that earn more than NIS 231,000 a year concurrent with a continued decrease in the proportion of workers earning relatively low wages (Figure 1.25).

Figure 1.24
Index of Real Wage per Employee Post in Banking, Insurance and Other Financial Institutions vis-à-vis the Business Sector and the Whole Economy, 1994-2005 (100=1994)

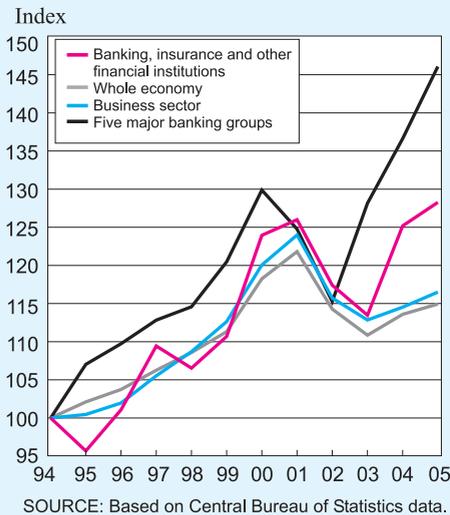
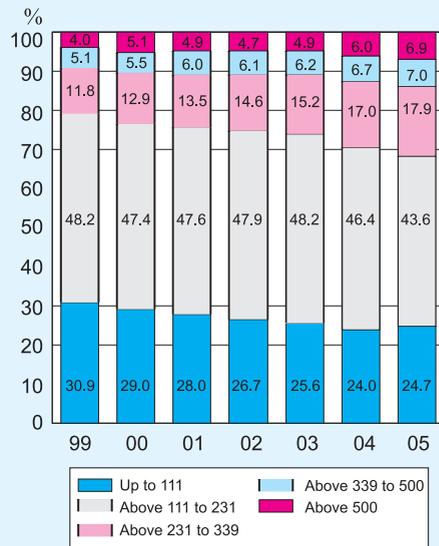


Figure 1.25
Distribution of Employees by Salary in the Commercial Banks, 1999-2005 (annual salary, NIS thousand)

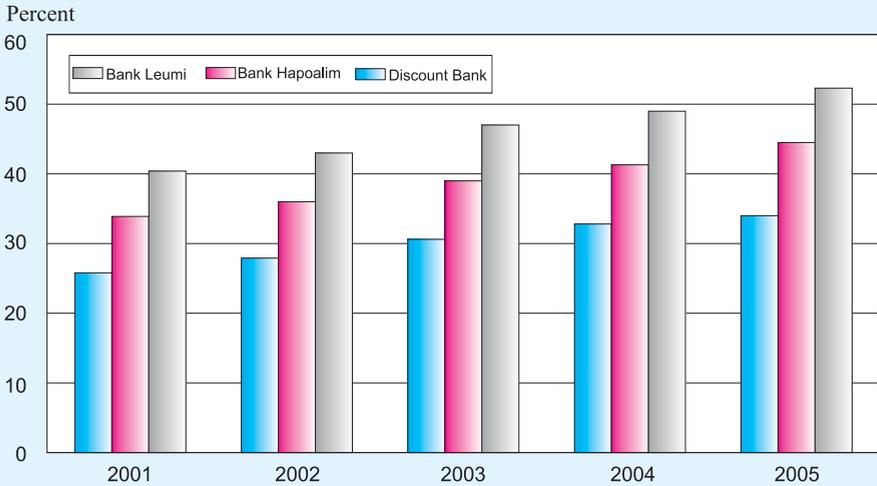


The rate of employees in the banking system with university education also consistently rises, which may explain some of the growth in wages (Figure 1.26).

In analyzing the rate of wages and related expenses in the banking system out of total added value²⁰ (which is a common index in professional literature for output of the banking system) it was found that in the Israel Discount group, the proportion of wages was the highest in the system for the past six years, at 68 percent, compared to an average of 50 percent in the system (Figure 1.27).

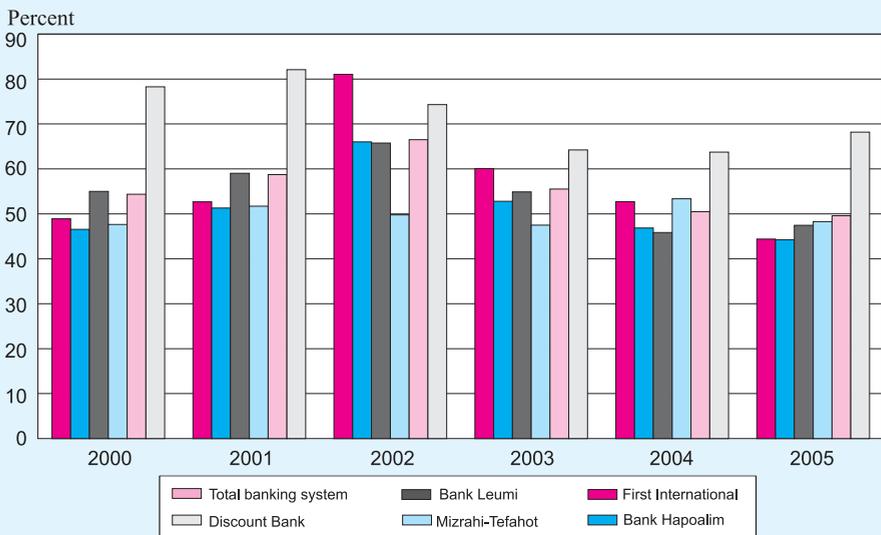
²⁰ Added value includes total net profit before tax, total wage expenses, depreciation and building and equipment maintenance.

Figure 1.26
Proportion of Employees with Higher Education in the Three Major Banking Groups, 2001-05



SOURCE: Published financial statements.

Figure 1.27
Salary Expenses^a as a Proportion of Value Added^b in the Five Major Banking Groups, 2000-05

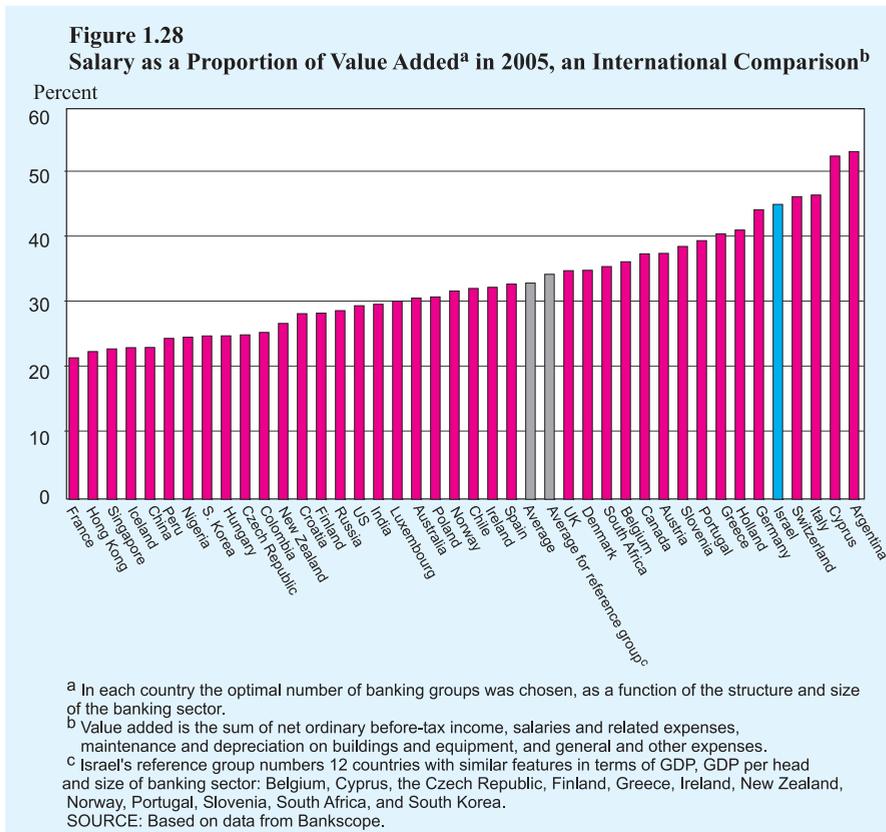


^a Salary expenses include severance pay, benefits, advanced training funds and vacation pay, national insurance, employers tax and payroll tax, related expenses and early retirement expenses.

^b Value added is the sum of net ordinary before-tax income, salaries and related expenses, maintenance and depreciation on buildings and equipment.

SOURCE: Published financial statements.

In international comparison²¹ it is seen that in the Israeli banking system, the rate of wage expenses and associated expenses out of the total added value is higher than both the global average and median (Figure 1.28).



3. ANALYSIS OF PERFORMANCE BY SEGMENTS OF ACTIVITY²²

At the beginning of the 2000s, some of the large banking groups began to restructure their organizations, divided by segment of activity, with each constituting a profit center.

²¹ The added value for international comparison was calculated as the amount of profit from regular activity before taxes, plus wage expenses, maintenance, depreciation of buildings and equipment and other general expenses.

²² Each banking group defines the segments of activity as it sees fit according to characteristics and size of its clients' activities. In general, the household segment comprises private clients with low-medium levels of financial wealth; the private banking segment comprises private clients with high financial wealth; the small business segment comprises corporate clients with low levels of business activity; the commercial segment comprises corporations with high levels of business activity; and the business segment comprises companies with high turnovers and debts.

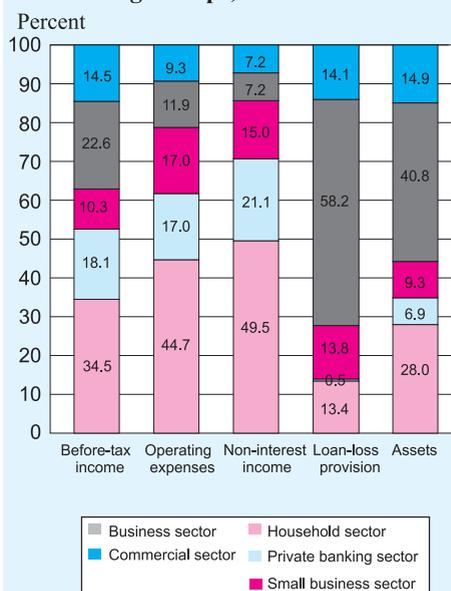
This division enables the banks' management to analyze their financial results and make appropriate decisions. Under Bank of Israel directives,²³ a segment of activity must fulfill three conditions; engage in business activities from which the bank is likely to produce income and incur expenses; the results of its activity must be examined on a regular basis by the management and the board of directors for the purpose of making decisions regarding the allocation of resources to the segment and the assessment of its performance; separate financial information on it can be found. In July 2005 the Supervisor of Banks redefined the segments of activity according to types of products and services or types of clients.²⁴ In the following analysis, we concentrate on the five major segments; the business segment, the commercial segment, the small businesses segment, the private banking segment and the household segment.

As in the previous year, this year the two most profitable segments were those of households and business, and within the business segment the commercial segment saw its profits rise by 59 percent, and its share of total profits increased from 10.5 percent in 2004 to 14.5 percent this year (Figure 1.29).

Despite the improvement in the state of the economy and growth in profits, the levels of activity of the business and the private banking segments fell, which could be seen in the drop in average balance of assets in each of the two segments compared to the previous year. This contraction stemmed apparently from the entry of the insurance companies and institutional investors into the field of financing activity to the business segment.

The trend of improvement in the Israeli economy in recent years can be seen clearly in a number of ways; the balance of loan-loss provisions fell this year by 20 percent compared to the previous year, and the contraction this year encompassed all segments of activity. The most notable were the private banking and the commercial segments, which each saw a reduction in

Figure 1.29
Contribution of Different Areas of Activity^a to Selected Items in the Financial Statements of the Five Major Banking Groups,^b 2005



^a Not including financial management sector, others and adjustments.

^b Hapoalim, Leumi, Discount, Mizrahi and First International.

SOURCE: Published financial statements.

²³ Directives on reporting to the public (12/01) (9) annual financial report, paragraph 79 (Principal Segments of Activity).

²⁴ Business, commercial, small businesses, private banking, household and financial management and other.

Table 1.16
Performance Indicators in the Five Major Banking Groups,^a by Sector, 2004–05

Components of profit	2004					2005						
	Households	Private banking sector	Small businesses	Business sector	Commercial sector	Total ^b	Households	Private banking sector	Small businesses	Business sector	Commercial sector	Total ^b
Average balance of assets	26	8	9	43	14	100	28	7	9	41	15	100
Net interest income before loan-loss provision	33	13	15	27	13	100	31	12	15	29	14	100
Loan-loss provision	13	1	14	54	18	100	13	1	14	58	14	100
Non-interest and other income	47	21	16	9	7	100	50	21	15	7	7	100
Operating expenses	44	18	18	11	9	100	45	17	17	12	9	100
Ordinary before-tax profit	39	21	9	21	10	100	34	18	10	23	15	100
Net profit	38	20	9	22	11	100	32	18	10	24	15	100
Ratios						(%)						(%)
Loan-loss provision to total assets	0.4	0.1	1.3	1.1	1.1	0.9	0.3	0.1	1.0	1.0	0.7	0.7
Profit from financial activity to total assets	4.4	5.3	5.4	2.1	3.1	3.4	3.9	5.9	5.6	2.4	3.2	3.5
Total income ^c to total assets	3.3	4.8	3.1	0.4	0.9	1.8	7.6	12.3	8.9	2.8	4.2	5.6
Operating expenses to total assets	5.3	6.8	5.9	0.8	2.0	3.1	5.5	8.5	6.3	1.0	2.2	3.5
Before-tax profit per shekel of assets	2.0	3.3	1.3	0.6	1.0	1.3	1.7	3.7	1.6	0.8	1.4	1.4
Return on equity	0.43	0.66	0.13	0.05	0.07	0.4	0.27	0.71	0.11	0.05	0.11	0.30
Coverage ratio ^d	0.62	0.71	0.53	0.44	0.48	0.59	0.67	0.76	0.53	0.37	0.47	0.61
Efficiency ratio ^e	1.45	1.50	1.44	3.08	2.04	1.70	1.38	1.44	1.41	2.78	1.95	1.62
Return per unit of risk ^f	9.99	69.81	4.06	2.01	2.86	4.01	11.39	112.00	5.30	2.41	4.77	4.90

^a Each banking group defines the sectors of its activity using its discretion and in accordance with the characteristics and extent of its customers' activities. In general, the household sector consists of private customers with low to medium financial wealth; the private banking sector consists of wealthy private customers; the small business sector consists of commercial customers with a low level of business activity; the commercial sector consists of businesses with a high level of activity; the business sector consists of companies with high sales turnover and indebtedness.

^b Not including the financial management sector, others, and adjustments.

^c Total income is defined as the sum of non-interest and other income plus net interest income before loan-loss provision.

^d Calculated as the ratio between total non-interest and other income to total operating and other expenses.

^e Calculated as the ratio between total non-interest and other income and profit from financial activity to total operating and other expenses.

^f Calculated as the ratio of before-tax profit plus provisions to the total loan-loss provision.

SOURCE: Based on published financial statements.

their loan-loss provisions of more than 30 percent, and the small businesses segment which saw its provisions drop by 17 percent (Table 1.16).

The improvement in the state of local industries, in which most of the clients in the commercial and small businesses segments operate, and the growth in local demand are the major factors in the improved quality of borrowers' credit in these two segments and the consequential fall in loan-loss provisions. As for the slight improvement in the private banking clients' ability to repay, it is reasonable to assume that this stems from the rises in the local capital market and the increasing accessibility of foreign capital markets to Israeli clients. In contrast to these two segments, the business segment registered a drop of 6 percent in its loan-loss provisions. This provision fell in only three of the five banking groups—Hapoalim, First International and Mizrahi-Tefahot—and is a result of the improved credit portfolio of the segment clients and the collection of debts for which provisions had been made in the past, due to the improved state of the economy. In the household segment annual loan-loss provisions fell by 12 percent this year, due to borrowers' improved ability to repay, and as a result of the drop in unemployment, the increased number of employees, the rise in average wages in the economy, growth in national insurance payments etc.

The policy of risk reduction, carried out by the large banks in recent years, continued this year and was expressed in the relatively stable level of competition in enlisting private clients in the private banking and household segments; this policy aims to take advantage of the large contribution and stability of these clients to bank profits.

In Directive 432 on Proper Conduct of Banking Business²⁵ concerning transfer of activities and the closing of a bank account, the granting of permission to operate in the insurance market and to remove provident and mutual funds from bank ownership were designed to improve mobility and boost competition. However despite the competition between the banks and the entry of the credit card companies into the field of extending credit to retail clients, the level of competition in this industry remains insufficient and is affected by the dominance in the market of the two largest banks.

Directive 432 is accompanied by the "package deal" concerning fees charged on a current account for private clients, that includes, inter alia, reference to fees for closing a bank account and transferring activities to another bank; the application of the "package deal" is the result of the Supervisor of Banks' involvement, and its aim is to prevent situations in which high fees deter clients from transferring their activities from one bank to another, thus harming competition.

Calculating the ratio of total financial and operating income²⁶ to the average balance of assets, to obtain an estimate of effective income for granting credit, shows that the highest ratios are obtained for the small businesses segment (8.92 percent), the private banking segment (12.29 percent) and the household segment (7.61 percent), while the

²⁵ Directives on Proper Conduct of Banking Business, July 2005.

²⁶ Total income calculated as the sum of operating and other income and profit from financial activity before loan-loss provision.

lowest ratios were found in the business segment (2.81 percent) and the commercial segment (4.21 percent) (Table 1.16).

Operating costs of the small businesses, private banking and household segments are higher than those of the business and commercial segments, as reflected by the high proportion operating costs are in these segments to total operating expenses; these high costs are explained by the extensive expenditures on human and physical resources involved in operating and maintaining a widespread network of branches. The household segment's share of total operating expenses this year reached 44.7 percent, while the private banking segment totaled 17 percent, as did the small businesses segment. The proportions of the business and commercial segments were lower at 11.9 percent and 9.3 percent respectively (Table 1.16, Figure 1.29).

An examination of the operational coverage ratio²⁷ in each segment shows that the private banking segment (0.76), the household segment (0.67) and the small businesses segment (0.53) were characterized by high coverage ratios. These high ratios can be explained apparently by the increase in the operating income component, as described above. In contrast the business segment (0.37) and the commercial segment (0.47) had lower coverage ratios, explained by the limited number of business centers. A further measure of operating efficiency is the efficiency ratio²⁸ which is low in the private banking segment (1.44), the household segment (1.38) and the small businesses segment (1.41) and high in the business segment (2.78) and the commercial segment (1.95) (Table 1.16).

In order to examine the efficiency of the segments in reference to the risks associated with the activity in each, we calculated the ratio of profit before tax divided by the balance of loan-loss provisions (which expresses the risk). This ratio is an approximation to the RAROC (risk-adjusted return on capital). The results obtained show that performance in the private banking and household segments were the best, while the performance in the small businesses, commercial and business segments were less so (Table 1.16).

In dividing the banking activities into retail banking and corporate banking, as instructed by the Basel II accord, the household, private banking and small businesses segments will be defined as retail banking while the commercial and business segments will be defined as corporate banking. While these categories may be similar in size, measured by average asset balance, the contribution of corporate banking to profits is significantly lower than the contribution of retail banking, due to the loan-loss provisions which in corporate banking are 2.5 times higher than in retail banking. This finding is expressed in the difference of performance in the two sectors, which is given here by the net profit before tax divided by total loan-loss provisions, a ratio that, as stated earlier, is close to RAROC. This ratio in retail banking is higher than in corporate banking (4.50 compared to 1.02).

²⁷ Calculated as the ratio of operating and other income to operating and other expenses.

²⁸ Calculated as the ratio of operating and other income and profit from financial operations to total operating and other expenses. The higher this ratio, the higher the operating efficiency, and vice versa.

4. ANALYSIS OF THE BANKS' PERFORMANCE ON THE BASIS OF THE MARKET-TO-BOOK RATIO²⁹ OF THEIR SHARES

The MV/BV ratio expresses the extent of the adjustment between the market value of a bank's equity as assessed by investors (net worth) and the book value of its capital. When the ratio is greater than 1, this means that the investor public appraises the bank in excess of its balance-sheet value, reflecting their opinion of a higher potential inherent in it. When the ratio is less than 1, this means that the investors regard the book value as an overestimation of the real net worth of the bank's equity.

In examining the developments of this ratio in the past three years, we see that from the beginning of 2003, after three years of continual decline in this ratio, investors changed their assessment and expected a substantial improvement in the banking groups' performance (Figure 1.30). These expectations did indeed materialize with the publication of the banks' favorable results in 2003, 2004 and 2005. This was reflected by a continuous rise in the MV/BV ratio for all banks during those years. In December 2004 the average ratio for the group of commercial banks had again crossed the value of 1 and stood at 1.11, and in December 2005 it reached 1.55. Despite the improved business results of the banks in the second half of 2006, this ratio worsened due to the continued improvement in the banks' book value, while at the same time their market value fell, as did the market in total.

In various papers written on this subject by the research unit of the Banking Supervision Department, it was proven that the MV/BV ratio of the five largest banks was positively affected by the ROE (return on equity) and negatively affected by bank risk.³⁰ The risk was calculated using various indices of credit risk, detailed in Part 3 of this survey, as well as indices of risk derived from the capital market, such as beta, which expresses the systemic risk which an individual investor can diversify, and k,

²⁹ The ratio is defined as Market-to-Book Ratio = $(MV/BV)_i$
where,

MV_i is the market value of shares and options in bank i in period t. The market value of any company is defined as the value of its shares and options that are listed for trading (excluding convertible bonds). The market value also includes shares that are not listed for trading but to which the market price of shares that are listed for trading is attributed,

and BV_i is the balance-sheet value of shareholders equity, including paid-up share capital, funds and surpluses of bank i.

For more details see David Ruthenberg and Shaul Pearl, "Market to Book Ratio of the Banks' Shares in Israel," Banking Supervision Department, Research Unit, Bank of Israel, discussion paper, 04.01 version, June 2004.

³⁰ This relationship is based on the MV/BV equation formulated as follows: $MV/BV = (ROE-g)/(k-g)$
where,

ROE – return on equity,

g – rate of growth of the bank,

k – the bank's risk.

For further details on this subject see Ruthenberg and Pearl (Ibid.)

which expresses the cost of raising capital or the required rate of return on an individual investment³¹ (Figure 1.31).

Figure 1.30
Ratio of Market Value to Book Value (MV/BV) of the Five Major Banks,
March 1993 to June 2006

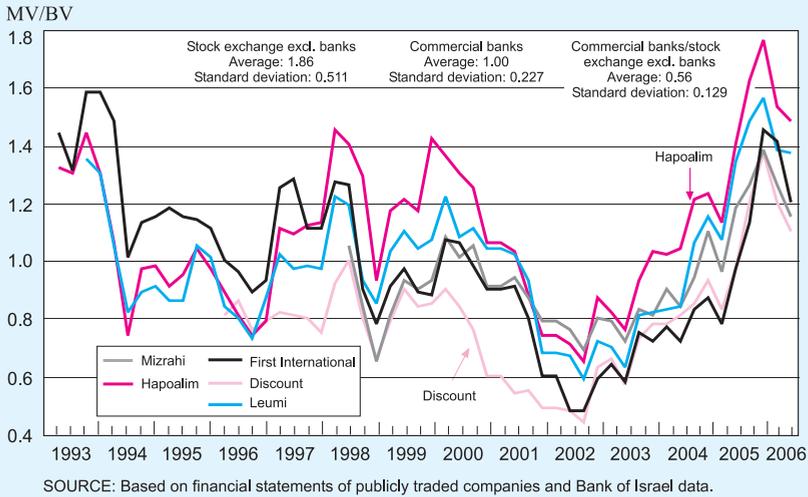
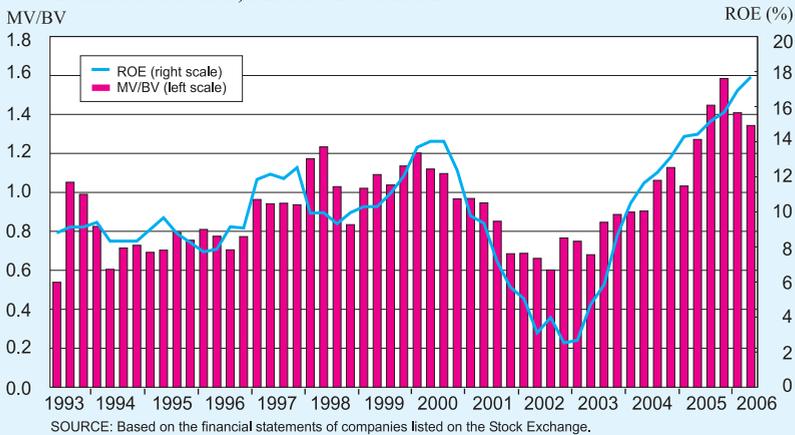


Figure 1.31
Return on Equity (ROE) and the MV/BV Ratio of the Five Major
Commercial Banks, June 1993 to June 2006



³¹ Based on a CAPM model, the cost of raising capital, k , was calculated by running beta (β) obtained in a separate estimation on the following equation: where, considered the risk-free rate of return, is the real rate of return on the redemption of five-year indexed government bonds, and the market rate of return, is the rate of return on an investment in the TA-100 index. For more details see Ruthenberg and Pearl (Ibid.).